***United States Court of Appeals***

***for the Second Circuit***


# APPELLANT'S BRIEF

75 4227

To be argued by
James B. Lewis

UNITED STATES COURT OF APPEALS

For the Second Circuit

ESTATE OF EDWIN C. WEISKOPF, Deceased,
ANNE K. WEISKOPF and SOLOMON LITT,
Executors, and ANNE K. WEISKOPF,
Surviving Wife,

Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

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On Appeal from the United States Tax Court

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# BRIEF FOR PETITIONERS-APPELLANTS

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## Preliminary Statement

This is an appeal from a decision of the United States Tax Court (Wiles, J.) finding deficiencies in the income tax of the appellants for the calendar year 1966.

The Findings of Fact and Opinion of the Tax Court, filed April 17, 1975, is reported at 64 T.C. 78 (1975). The decision of the Tax Court was entered on July 17, 1975. The notice of appeal to this Court was

filed on October 6, 1975. Jurisdiction is based upon sections 7482 and 7483 of the Internal Revenue Code of 1954 (the "Code").

## Issues Presented for Review

Was Ininco, Ltd. a controlled foreign corporation? If so, to what extent should gain realized upon the sale of stock of Intapco, Inc., be taxed under section 1248 of the Code?

## Statement of the Case

In 1963 Whitehead and his father, Weiskopf, were the stockholders of a group of corporations engaged in the manufacture and sale of scientific equipment, including a United Kingdom manufacturing corporation. On the suggestion of British counsel, they decided in 1963 to organize another United Kingdom corporation to be qualified as an overseas trade corporation in order to gain exemption from United Kingdom income and profits tax on income from export sales from the United Kingdom to other countries. 1/

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1/ The tax exemption then provided by the United Kingdom to overseas trade corporations somewhat resembled, but was more generous than, the benefits now provided by the United States to domestic international sales corporations (Sections 991 et seq. of the Code) and to Western Hemisphere trade corporations (Sections 921 et seq. of the Code).

Acting on the further advice of British counsel that a privately-controlled overseas trade corporation would be open to a surtax direction,[2/] Whitehead and Weiskopf, through British counsel, asked a British-owned publicly-held United Kingdom investment holding company (Unex) to participate in the organization of the overseas trade corporation.

In November 1963 the overseas trade corporation (Ininco) was organized. For that purpose, Whitehead and Weiskopf created a United States corporation (Intapco). Intapco and Romney (a wholly-owned British subsidiary of Unex) then organized Ininco under the laws of the United Kingdom, Romney investing 25,000 pounds in return for first preferred stock and Intapco 20,000 pounds in return for second preferred and common stocks.[3/] The first preferred stock received by Romney had a par value of 25,000 pounds and bore an annual cumulative dividend of 12-1/2 percent. The first preferred shares (250 in number) and common shares (also 250 in number)

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2/ A surtax direction under United Kingdom law was somewhat similar to the accumulated earnings tax imposed in the United States (Sections 531 et seq. of the Code).

3/ In describing the three classes of stock, we have, to avoid the use of unfamiliar terms, substituted United States terminology for the United Kingdom terminology actually used in the articles of association of Ininco.

were entitled to one vote per share, and the majority of either such class of stock was entitled to appoint not more than two directors of Ininco. 4/ Romney voted its first preferred shares for the appointment of Bernard Franklin (a chartered accountant and a member of the boards of directors of Unex and Romney) and Maurice Goldwater as directors, and Intapco voted its common shares for the appointment of Whitehead and Weiskopf as directors.

In the formation of Intapco, Whitehead subscribed to its common stock and Weiskopf to its preferred stock. Weiskopf had the option, exercisable only during his lifetime and if certain conditions were met, to convert a portion of his preferred stock into a 50 percent common stock interest in Intapco.

In 1965 the United Kingdom enacted legislation, effective as of April 6, 1966, abolishing the tax exemption that had been accorded to overseas trade corporations. British counsel thereupon recommended that Ininco should no longer be utilized for sale of Technicon products, since it would no longer be able to serve its

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4/ The second preferred stock had no voting rights.

United Kingdom tax objective, and that it should be disposed of. He also noted that, although liquidation of Ininco by Romney and Intapco would incur a 40 percent United Kingdom tax, sale of Ininco to a nonresident would avoid that tax.

Accordingly, British counsel negotiated the sale by Whitehead and Weiskopf of their Intapco stock to an unrelated Hong Kong company. In anticipation of the sale, Weiskopf exercised his option to convert a portion of his Intapco preferred stock into a 50 percent common stock interest in Intapco. British counsel then asked Romney to sell its Ininco stock to the Hong Kong purchaser. Romney at first objected, and then asked that it receive a premium for agreeing to sell. The premium was agreed to in the form of an additional dividend on the Ininco first preferred shares held by Romney.

In February 1966, by which time Ininco had ceased to market Technicon products, Whitehead and Weis-Kopf sold the stock of Intapco to the Hong Kong purchaser. The Hong Kong purchaser also purchased Romney's stock interest in Ininco, and then became the sole stockholder of Ininco by liquidating Intapco. Having obtained a favorable tax authorization from the United Kingdom

Inland Revenue office, permitting it to withdraw dividends from Ininco free of United Kingdom tax, the Hong Kong purchaser withdrew substantial dividends during March. The Hong Kong purchaser also proceeded to cause Ininco to wind up its business, including the collection of receivables, and, in May 1966, liquidated Ininco.

Whitehead realized a gain of $1,093,654.16 and Weiskopf a gain of $1,106,220.17 upon sale of the Intapco stock. They reported their gain as long-term capital gain. The Tax Court subjected the gain to tax under the provisions of section 1248 of the Code.

## Argument

In its zealous effort to expand the scope of the tax provisions of section 1248 of the Code, the Tax Court committed three serious errors:

First, the Tax Court treated Ininco as a controlled foreign corporation as defined in section 957(a) of the Code.

Second, the Tax Court treated the sale by Whitehead and Weiskopf of their Intapco stock as though that transaction were in fact the liquidation of Ininco.

Third, the Tax Court treated Weiskopf as though he had owned one-half of the common stock of Intapco continuously from the date of its organization to the date of its liquidation.

We deal below with each of the three errors.

## I

## The Tax Court erred in treating Ininco as a controlled foreign corporation

A foreign corporation is not a controlled foreign corporation unless United States shareholders own "more that 50 percent of the total combined voting power of all classes of stock entitled to vote." Section 957(a) of the Code. Treas. Reg. § 1.957-1(b)(2) provides that "any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." In Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974), this Court agreed with that regulation and held "that it is 'real' voting power and not the mere mechanical number of votes

with which Congress was concerned" when it enacted section 957 of the Code. 489 F.2d at 201. In Kraus v. Commissioner, 490 F.2d 898 (2d Cir. 1974), this Court confirmed that principle. "In determining whether 'real' voting power was surrendered, we look to the actualities stressed in Garlock and in Treasury Regulation section 1.957-1(b)(2)." 490 F.2d at 901.

The Tax Court, while paying lip service to Garlock and Kraus and the regulations, formulated a totally different approach in its decision below. The core of the Tax Court's decision was that "Whitehead and Weiskopf retained control and dominion over Ininco despite Romney's 50-percent voting rights" because they controlled "Ininco's only product line." By shutting off Ininco's source of supply, Whitehead and Weiskopf could "'essentially' terminate its business." 64 T.C. at 95.

The Tax Court has inexplicably entangled the subject of voting power with that of control over the corporation's product line. No degree of stockholder voting power, however real, will suffice to lay claim to the business of a supplier. Commerce abounds in proof of what the Tax Court asserts is difficult to believe:

thousands of dealerships, distributorships, franchises, and other agencies, owned wholly or partly by independent businessmen, are dependent upon, and have little or no rights of ownership in, functionally related businesses.

The voting rights of stockholders are to elect the corporate board and to vote on major corporate action, such as merger, liquidation or sale of assets. These were the voting rights that were found in Garlock and Kraus to be illusory. By the tests applied in those cases, Romney's voting rights were real. Garlock, Kraus and the regulations contain no basis for the Tax Court's surprising concern with the subject of business control over product lines.

The Tax Court's opinion below is all the more surprising when compared with an opinion in another case written by the same judge less than a month later. CCA, Inc., 64 T.C. 137 (1975). The CCA opinion could have been written for this case. Both cases involved foreign investment in preferred stock; the only restriction on the foreign-held stock was one on transfer (compare 64 T.C. 150 with 64 T.C. 84); the board of directors was evenly split between representatives of the common and

preferred shareholders (compare 64 T.C. 151 with 64 T.C. 83 and 86); there were no provisions for breaking deadlocks (compare 64 T.C. 151 with 64 T.C. 86); the foreign stock interest to be protected by exercise of stockholder voting power bore a fixed dividend (compare 64 T.C. 151 with 64 T.C. 83); the foreigners participated in meetings of shareholders and directors (compare 64 T.C. 152 with 64 T.C. 86); no strings were imposed on the foreign-held voting power (compare 64 T.C. 153 with 64 T.C. 81-86).

In CCA the Tax Court applied the tests of reality of voting power developed in Garlock and Kraus and in the regulations; in this case it did not do so. The result in this case displaced the statutory test of voting power with that of economic dependence and should be reversed.

II

The Tax Court erroneously treated the sale by Whitehead and Weiskopf of the Intapco stock as though that transaction were the liquidation of Ininco.

Having erroneously brought this case within section 1248, the Tax Court has also overstated the impact of section 1248 by disregarding the fact that appellants sold their Intapco stock and treating them as though they had instead liquidated Ininco. 64 T.C. at 98-101.

A. The decision of corporate shareholders to dispose of their stock by sale controls for tax purposes.

The Tax Court held that "[e]ven though a transaction is put in the form of a sale, if it in fact results in an effective liquidation, it will be given such recognition." 64 T.C. at 100. The development and interpretation of the income tax law show the Tax Court's statement to be in error.

For example, a parent corporation is not permitted to realize the loss on its investment in the stock of a subsidiary upon liquidation of the subsidiary. Section 332 of the Code. This is true even though the parent receives nothing but money on the liquidation. Tri-Lakes S.S. Co. v. Commissioner, 146 F.2d 970 (6th Cir. 1945). The parent may, however, obtain the tax use of the loss on its stock investment by selling the stock of the subsidiary to a third party. Alternatively, the parent may obtain the tax loss by selling 21 percent of the stock to a third party and then liquidating the 79-percent owned subsidiary. Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956); Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945). A sale of shares, even though

not consummated until after the decision to liquidate has been made, is nevertheless a sale. Granite Trust Co., supra; Avco Mfg. Corp., 25 T.C. 975 (1956), vacated and remanded, 57-2 U.S.T.C. ¶ 10,021 (2d Cir. 1957).

Where ownership of stock changes hands in anticipation of the liquidation of the corporation, it is the purchaser and not the seller that attracts the tax consequences of the liquidation. Madison Square Garden Corp. v. Commissioner, 500 F.2d 611 (2d Cir. 1974); George L. Riggs, Inc., 64 T.C. 474 (1975); Rev. Rul. 75-721, 1975-48 Int. Rev. Bull. 10. "[T]he measurement of control" -- i.e., of the identity and quantum of stock ownership -- "is to be made on the date the liquidation plan is adopted and the assets distributed." Madison Square Garden Corp., supra, 500 F.2d at 613.

Obviously, therefore, shareholders may dispose of corporate ownership either by sale of their stock or by liquidation of the corporation. The option to sell or to liquidate is that of the taxpayer. The tax result turns on the choice made by the taxpayer.

Because of its realization that shareholders have that choice, Congress has, as a matter of practical

necessity, provided generally similar tax consequences to sale and liquidation. Since 1924 a liquidating distribution has been treated as the proceeds of a sale of the stock by the shareholder. Section 331 of the Code. "Treating such a transaction as a sale and within the capital gain provisions . . . is the only method of treating such distributions which can be easily administered." S. Rep. No. 398, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 (Part 2) Cum. Bull. 266, 274.

The sale of stock to a purchaser who intends to liquidate the purchased corporation is a common form of transaction. 5/ The purchaser's intent to liquidate has not customarily been imputed to the seller. Indeed, the Tax Court is unable to cite any authority other than two recent questionable opinions of its own. 64 T.C. at 100. These are John D. Gray, 56 T.C. 1032 (1971), which has been appealed to the Ninth Circuit by the taxpayer, and E. Keith Owens, 64 T.C. 1 (1975), in which four Tax Court judges (including the trial judge) dissented and in which a decision permitting appeal has not yet been entered. Since Gray and Owens are still under judicial scrutiny,

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5/ See Kimbell-Diamond Milling Co. v. Commissioner, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951); Dallas Downtown Development Co., 12 T.C. 114 (1949); Steubenville Bridge Co., 11 T.C. 789 (1948); Section 334 (b)(2) of the Code; Lewis & Schapiro, Sale of Corporate Business: Stock or Assets?, 14 N.Y.U. Inst. on Fed. Tax. 745 (1956).

their disharmonious doctrine that the purchaser's intent to liquidate should be charged to the seller is dubious precedent.

Even if Gray and Owens were to become reliable precedent, they are readily distinguishable. Those cases dealt with sales, involving a predetermined profit to the purchaser, of fixed amounts of incorporated cash. In this case, however, the purchaser did not secure a predetermined profit and Ininco's assets had not been reduced to cash. Ininco was still engaged in the collection of receivables, which was a necessary part of the winding up of its business. "[L]iquidation is as much a part of the original venture as its active conduct," Hand, C.J., in J. Ungar, Inc. v. Commissioner, 244 F.2d 90, 92 (2d Cir. 1957). "[A] corporation in process of liquidation is still in existence, if it retains assets to pay its debts, or indeed to distribute among shareholders." Id. at 93.

Section 1248 and the regulations and rulings thereunder clearly recognize that the shareholder of a controlled foreign corporation may sell his stock, for they prescribe the tax treatment of such a transaction in detail. The selling shareholder is taxed under section 1248 only on the earnings and profits accumulated while he

held the stock (i.e., up to the date of its sale). Section 1248(a) of the Code. For this purpose, earnings and profits accumulated during the taxable year in which the stock was sold are prorated on a daily basis between the portions of the taxable year before and after the sale. Treas. Reg. § 1.1248-3(c)(1). Dividends distributed to the purchaser during the balance of the taxable year reduce accumulated earnings and profits for the year for the purposes of the section 1248 tax computation. Rev. Rul. 71-388, 1971-2 Cum. Bull. 314.

The United Kingdom Inland Revenue office ruled on the sale-versus-liquidation question contemporaneously. Like the umpire in a baseball game, Inland Revenue had the best view of the transaction. Inland Revenue also had a substantial stake, since a determination that Ininco was liquidated by its original owners would have produced a 40 percent United Kingdom tax. The issuance by Inland Revenue of the authorization for payment of dividends from Ininco to the foreign purchaser without deduction of United Kingdom tax attests to the actuality of the sale of stock.

The Tax Court conceded that there was no agreement by the purchaser to liquidate Ininco. 64 T.C. at 101. Nevertheless, the Tax Court somehow managed to reach the confused conclusion that "the sale of Intapco stock was in substance a liquidation of Ininco at that time, with the remaining distributions made to . . . [the purchaser] being liquidating distributions." Ibid. If Ininco's corporate existence was terminated by complete liquidation upon the sale of the Intapco stock, how could Ininco have made two liquidating distributions to the purchaser some weeks later?

B. Since Intapco and Ininco were separate corporations not under common ownership, sale of the Intapco stock was not in substance the liquidation of Ininco.

Under the above principles, even if Whitehead and Weiskopf had owned Ininco directly and wholly, they could have chosen either to sell their stock or to liquidate Ininco, with tax consequences appropriate to the transaction effected. Had they chosen to sell, the Tax Court would have erred in taxing them as if they had liquidated.

The Tax Court's error is compounded by the fact that Whitehead and Weiskopf did not have the right

to liquidate Ininco. They owned stock in Intapco, not in Ininco. Intapco had only one-half of the voting power in Ininco, and was, therefore, powerless to liquidate Ininco without the cooperation of Romney.

The creation and existence of Intapco served the business purpose of giving Weiskopf a preferred stock interest and Whitehead a common stock interest in the enterprise without complicating the stock structure of Ininco and relations with Romney. By application of the doctrine that "the corporate 'form' must be 'unreal or a sham,' before the Treasury may disregard it" (L. Hand, C.J., in National Investors Corporation v. Hoey, 144 F.2d 466, 467 (2d Cir. 1944)), the separate corporate existence of Intapco must be respected.

The Tax Court's strained result cannot be reached by treating the sale of the Intapco stock as though it were the liquidation of Intapco. In section 1248 computations, Intapco is treated as a first-tier foreign corporation and Ininco as a lower-tier foreign corporation. Section 1248(e) of the Code; Treas. Reg. § 1.1248-6(b)(1). That portion of the earnings and profits of Ininco for its final taxable year prorated on a daily basis to the portion of that year extending

beyond the date of liquidation of Intapco must be excluded. Treas. Reg. § 1.1248-3(f)(2)(ii)(a).

The Tax Court's fanciful conclusion that the sale of stock of one corporation is, in effect, the liquidation of a lower-tier corporation owned partly by an unrelated stockholder who can block liquidation is reversible error.

III

The Tax Court erred in attributing one half of the earnings and profits of Ininco to Weiskopf.

During 1964, 1965 and a portion of 1966, Weiskopf's interest in the earnings and profits of Ininco was limited to a fixed dividend on preferred stock.

The Tax Court recognized that the applicable regulations require allocation of earnings and profits among shareholders year by year and on a daily basis in accordance with the amount of earnings and profits that would be distributed to each of them on the last day of each taxable year with respect to their stock. 6/ 64 T.C. at 101-102. The Tax Court displaced that principle,

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6/ See Treas. Reg. § 1.963-2(d)(2)(i)(d), made applicable to section 1248 computations by Treas. Reg. § 1.1248-3(c)(4), and Treas. Reg. §§ 1.1248-3(c)(2), 3(f), and 4(f).

however, and attributed to Weiskopf one half of the earnings and profits of Ininco throughout 1964, 1965 and the relevant part of 1966, for the following reason:

> "Section 1.1248-1(a), Income Tax Regs., which petitioner does not attack, clearly provides that a shareholder is considered to have held his stock during the entire period to which section 1223 applies. In this case Weiskopf is considered to own the common stock from the inception of Ininco." 64 T.C. at 103.

The Tax Court misconceived the function of section 1223 as applied to stock in controlled foreign corporations, which is to ensure that tax consequences under section 1248 (which applies only to taxable dispositions) are preserved for eventual taxation. Section 1223 applies, for example, to transfers of stock from one taxpayer to another by gift or in a tax-free exchange, and causes the earnings and profits attributable to the stock to adhere to the stock in the hands of its new owner. Similarly, if a taxpayer receives new stock for old stock in a tax-free exchange, the earnings and profits attributable to the old stock are preserved by section 1223 for recognition upon a subsequent taxable disposition of the new stock.

Section 1223 thus performs in section 1248 cases its customary "tacking" function. It tacks to the common stock received by Weiskopf in the 1966 exchange the earnings and profits accrued with respect to the preferred stock surrendered.

The Tax Court's misuse of section 1223 to require retroactive reallocation of earnings and profits breaches the principle of annual accounting that has become a touchstone of taxation. See Commissioner v. Gordon, 391 U.S. 83, 96 (1968); United States v. Skelly Oil Co., 394 U.S. 678, 681 (1969). Moreover it produces unacceptable results, as illustrated below:

(1) Assume that A subscribes to all the common stock and B to all the preferred stock of a controlled foreign corporation. Following sale by A of all of the common stock, B exchanges his preferred stock for newly-issued common stock in a tax-free exchange and sells such common stock. Under the Tax Court's approach, B will have ordinary income under section 1248 measured by earnings and profits already productive of such income to A on the first sale, resulting in double taxation.

(2) Assume that a controlled foreign corporation issues on organization common stock to C and D.

In a later year, C exchanges all of his common stock for preferred stock in a tax-free exchange and sells the preferred stock. Under the Tax Court's approach C will escape recognition under section 1248 of tax upon the earnings and profits accrued with respect to the common stock surrendered in the exchange.

The Tax Court's misconstruction of section 1223 allocates excessive earnings and profits to Weiskopf and constitutes reversible error.

## CONCLUSION

The decision of the Tax Court should be reversed.

Dated: New York, New York
December 17, 1975

Respectfully submitted,

Paul, Weiss, Rifkind, Wharton
& Garrison
Attorneys for Petitioners-Appellants

James B. Lewis
Jose E. Trias

Of Counsel

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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EDWIN C. WHITEHEAD and JOSEPHINE WHITEHEAD,

Appellants,

-against-

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

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Docket No. 75-4227

CERTIFICATE OF SERVICE

I hereby certify that on December 17, 1975 I served 2 copies of the brief which was filed with the United States Court of Appeals for the Second Circuit on behalf of the above-named appellants on each counsel for the other parties to this appeal by depositing said copies in post-paid wrappers, one addressed to Scott P. Crampton, Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20530, attention George G. Wolf, Esq., and the other addressed to James B. Lewis, c/o Paul, Weiss, Rifkind, Wharton & Garrison, 345 Park Avenue, New York, New York 10022, in an official depository under the exclusive care and custody of the United States Postal Service within the State of New York.

Dated: December 17, 1975

Richard A. Levine

RICHARD A. LEVINE

AFFIDAVIT

STATE OF NEW YORK )
: ss.:
COUNTY OF NEW YORK )

GERALD ROKOFF, being duly sworn, deposes and says:

I am not a party to the action, am over 18 years of age and reside at 6625 103rd Street, Forest Hills, New York 11375.

On December 17, 1975 , I served the attached briefs upon the following attorney(s) at the address designated by him (them) for that purpose:

Scott P. Crampton
Assistant Attorney General
Tax Division
United States Department of Justice
Washington, D.C. 20530

Said service was made by depositing a true copy of the attached briefs enclosed in a postpaid properly addressed wrapper, in an official depository under the exclusive care and custody of the United States Post Office Department within the State of New York.

Gerald Rokoff
GERALD ROKOFF

Sworn to before me this
17th day of December , 1975.

Notary Public

MOLLIE SINGERMAN
Notary Public, State of New York
No. 31-3687200
Qualified in New York County
Commission Expires March 30, 1977